

AN ETHICAL DILEMMA IN THE AUDIT OF AMG, INCORPORATED

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CASE DESCRIPTION

The primary subject matter of this case concerns an ethical dilemma encountered during the audit of a publicly held company (registrant). It provides students with an opportunity to act in the role of an auditor and determine how to proceed with suspected fraud regarding accounts receivables and revenues. Students must consult the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct and the Public Company Accounting Oversight Board's (PCAOB's) standards on ethics and independence. The case has a difficulty level of four or five and is suitable for both undergraduate and graduate level auditing courses where professional ethics are covered. Further, the case can be used in an on-ground or online class environment as an individual or team assignment. The case is brief enough to be covered in a single class period and will likely require students invest an additional two or three hours outside of class.

Keywords: Ethical Dilemma, AICPA Code of Professional Conduct, PCAOB Ethics Standards.

CASE SYNOPSIS

This case is loosely based upon a Securities and Exchange Commission's Accounting and Auditing Enforcement Release and requires students to act in the role of an auditor conducting an audit of the annual financial statements of AMG, Incorporated, a manufacturer of a diverse range of products. Students are required to access the PCAOB's standards on ethics and independence, as well as the AICPA Code of Professional Conduct and then determine what would have been the best course of action in this case.

INTRODUCTION

Imagine yourself in the role of auditor, leading an audit of the financial statements of AMG, Incorporated (hereafter referred to as AMG) and a publicly traded manufacturer in Houston, Texas. You must decide how best to deal with some indications of fraudulent activity that involves accounts receivables and revenues. You recognize that that you need to refer to the AICPA Code of Professional Conduct as well as consult with the Partner on the audit engagement in order to determine next steps with regard to the audit.

BACKGROUND

This is your second year working full time for a small CPA firm. You have recently passed the CPA exam and become a member of the AICPA. For the first time, you have been assigned an audit of a publicly held company (registrant). It also happens to be your firm's first

publicly held client. Prior to accepting this audit client, your firm had only audited privately held clients. Thus, your auditing experience up to this point in time consists only of auditing privately held clients. An audit engagement letter is signed by your firm and by AMG's audit committee (a committee of AMG's board of directors) as required by the Public Company Accounting Oversight Board's (hereafter referred to as PCAOB) audit standards.

AUDIT OF THE FINANCIAL STATEMENTS

While conducting your preliminary analytical procedures during the first few days on AMG's audit, you discover that AMG's accounts receivables had increased 75 percent from the previous year. As you dig deeper and look at the accounts receivables transactions, you discover that during the third and fourth quarters, AMG recorded substantial sales towards the end of each quarter (typically in the last 10 business days of each quarter). As far as you can determine, each of these sales were for amounts that were considerably higher than those usually recorded by AMG. For instance, if the average sale during the third quarter was for \$25,000, then the average sale recorded near the end of the third quarter was for \$250,000 or more. These sizable and material sales were included in the quarter end aging of receivables reports that you were given by the client. When you examined the ancillary documents for these sales, you found sales invoices that described each quarter end sale as "*miscellaneous charges*." You were unable to find any other ancillary documentation, including purchase orders or shipping documents to support the sales transaction. In addition, you find that all of the quarter end material sales for the third quarter, were reversed in the first few business days of the fourth quarter. Although you find credit memos that account for the reversal showing that items had been returned to AMG, there is no support for issuance of the credit memos. You suspect that something similar had happened to the substantial sales recorded during the last 10 business days of the fourth quarter as well. This causes you concern and you begin to worry that there might be more going on here than you are able to detect.

As such, you request a meeting with the company's accounting manager. The accounting manager is reluctant to meet with you which raise your concern even more. When you finally have the opportunity to discuss the substantial increase in sales at the end of the third quarter and the subsequent reversal of these sales in the fourth quarter with the accounting manager, he explains that the increase was a result of sales made to five new customers for a new product that AMG had created. He also explained that a significant number of this new product turned out to be damaged when received by these customers and after consultation with the Chief Financial Officer (CFO), he was authorized to ask the new customers for all the items to be returned to AMG in exchange for full credit. He said that he will personally work on finding the additional supporting documentation including the purchase orders and the shipping documents in the next few days. You also ask him if the "*miscellaneous charges*" sales recorded at the end of the fourth quarter were reversed *via* credit memos in the first few days of the first quarter of fiscal 2016. He said that he did not recall, but that he would check his files and consult with the CFO and then get back to you.

You go back to your office and begin to question the validity of what is happening at AMG... wasn't it strange that all of the shipments of the new product to the new customers contained defective units? Not only that, a majority of the units shipped to each customer must have been defective for the CFO to authorize the return of the entire shipment. There did not appear to be any production problems with any of the other products manufactured by AMG.

You have other questions and concerns. Why was there no other documentation available for the quarter end sales as well as the credit memos? Why did the accounting manager need to consult with the CFO to answer your question about the fourth quarter end sales? You begin to suspect that fraud might be taking place at AMG. But you recall the “*Confidential Client Information Rule*” of the American Institute of Certified Public Accountant (AICPA) Code of Professional Conduct, which prohibits you from disclosing any confidential client information without the client’s consent. You are also aware that your firm is going to earn a substantial audit fee from AMG upon the completion of the audit engagement and do not want to do anything to jeopardize the earning of this fee. You consider your next steps, including consulting the AICPA Code of Professional Conduct and then presenting your findings to the Partner on the audit engagement.

INSTRUCTORS’ NOTES

Case Overview

This instructional case is loosely based upon Securities and Exchange Commission’s Accounting and Auditing Enforcement Release (AAER) No. 3146 dated June 24, 2010. Simione & Sheikh (2017), based an earlier case on the same AAER, however, the focus of that case was on helping students understand and use the relevant Public Company Accounting Oversight Board (PCAOB) standards on the review of interim financial statements of publicly held corporations (also known as registrants). In contrast, this case provides students with a real world example of a situation where there is an ethical conflict in the audit of a registrant client. Specifically, according to the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct Rule 1.000.020.01 (2018, 29), “*a member suspects a fraud may have occurred, but reporting the suspected fraud would violate the member’s responsibility to maintain client confidentiality*”. To answer the suggested discussion questions, students are required to access the PCAOB’s standards on ethics and independence, as well as the AICPA’s code of Professional Conduct and then determine the appropriate steps to take.

Suggestions for Classroom Use

The case is appropriate for an auditing course and best used in conjunction with coverage of the AICPA Code of Professional Conduct and discussion of ethical decision making frameworks. For example, in the Arens et al. (2017) auditing textbook, these topics are covered in Chapter 4. Use of cases provides an effective classroom technique that promotes learning and facilitates a more active classroom environment as evidenced in the literature (Bonney, 2015; Christensen & Carlile, 2009; Forsgren, 2014; Gallucci, 2006; Garvin, 2003; Naghi et al., 2018; Rivenbark, 2007; and Vega, 2013). However, few cases are available for use in teaching ethics in an auditing course (Cheng & Flasher, 2018; Jelinek, 2018; Langenderfer & Rockness, 1989). This case adds to the limited number of cases available for classroom use in an auditing course. It can be used in an online course or an on-ground class and on an individual or team basis. All of the discussion questions, except the first one, are intended to stimulate classroom discussion, however, they can also be used as written homework assignments if classroom time is limited, or as online discussion questions in an online class. The case can be utilized in a single class period and is expected to require student’s invest an additional two or three hours outside of class. The brevity of the case was intentional. Given the content coverage in the audit class, instructors

might be hesitant to use lengthy cases that require multiple classes as well as several hours outside of class (Cheng & Flasher, 2018). As noted, this case can be used in a single class period and allows instructors an opportunity to promote active learning.

Learning Objectives

This case affords students an opportunity to identify and then apply the ethical conflict resolution framework described in the AICPA (2018) “*AICPA Code of Professional Conduct*” (available at <https://pub.aicpa.org/codeofconduct/ethicsresources/et-cod.pdf>). It is important to note that in 2014, the AICPA revised the Code of Professional Conduct to be more user friendly. Specifically, the revised code is designed to be easier to navigate and is organized into three parts—one which applies to members in public practice, one which applies to members in business and one which applies to all other members including members who are retired or unemployed (AICPA, 2018 and Gorla, 2014). In addition, the AICPA Code of Professional Conduct now includes conceptual frameworks. These frameworks “*incorporate a ‘threats and safeguards’ approach and are designed to assist users in analyzing relationships and circumstances that the code does not specifically address*” (Gorla, 2014).

In our experience, most students are unaware that the AICPA has described a general ethical decision making framework and thus the first question helps them discover this specific framework. It is important to note that students may first go to the Public Company Accounting Oversight Board (PCAOB) website and look for the PCAOB’s standards on “*Ethics & Independence*” (available at <http://pcaobus.org/Standards/EI/Pages/default.aspx>). However, the students should discover quite quickly that these standards are not very helpful in resolving the ethical dilemma described in this case. Specific learning objectives include:

1. Understanding the ethical conflict resolution framework identified in “*1.000.020 Ethical Conflicts*,” (AICPA, 2018) for members in public practice [The same guidance is repeated in “*2.000.020 Ethical Conflicts*” (AICPA, 2018) for members in business] and
2. Applying the ethical decision making framework to questions that arise from a particular scenario that occurred in a real audit situation.

This case also gives students an opportunity to demonstrate professional skills in their solutions. Specifically, this case provides a tool for assessing student’s writing mechanics, ability to identify and understand audit related issues and analysis and application skills. We include three rubrics at the end of these teaching notes to facilitate the assessment and evaluation of student responses—one rubric for the discussion question responses, one rubric for determining whether the learning objectives are met and one rubric for assessing student’s professional skills.

Discussion Questions

The following suggested questions can be used by instructors as is or modified to serve their needs (Table 1 to Table 3)

1. What general guidance does the AICPA Code of Professional Conduct provide to auditors faced with an ethical dilemma? Provide specific citations in your answer.
2. What relevant facts and circumstances in this case should influence your ethical decision making process?
3. What is the ethical dilemma in this case?

4. Does your audit firm appear to have any specific internal procedures in place to deal with ethical dilemmas? If not, what internal procedures should your firm have in place?
5. What alternative courses of action are available to you? What would be the best course of action for you to take in these circumstances?

Solutions to Suggested Discussion Questions

1. What general guidance does the AICPA Code of Professional Conduct provide to auditors faced with an ethical dilemma? Provide specific citations in your answer.

For members in public practice, “1.000.020 *Ethical Conflicts*,” (AICPA, 2018) specifies the following framework for making ethical decisions (paragraphs 1 to 6). [The same guidance is repeated in “2.000.020 *Ethical Conflicts*” (AICPA, 2018) for members in business]:

An ethical conflict arises when a member encounters one or both of the following:

- a. Obstacles to following an appropriate course of action due to internal or external pressures.
- b. Conflicts in applying relevant professional standards or legal standards.

For example, a member suspects a fraud may have occurred, but reporting the suspected fraud would violate the member’s responsibility to maintain client confidentiality.

Once an ethical conflict is encountered, a member may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the member should consider factors such as the following:

- a. Relevant facts and circumstances, including applicable rules, laws, or regulations.
- b. Ethical issues involved.
- c. Established internal procedures.

The member should also be prepared to justify any departures that the member believes were appropriate in applying the relevant rules and law. If the member was unable to resolve the conflict in a way that permitted compliance with the applicable rules and law, the member may have to address the consequences of any violations.

Before pursuing a course of action, the member should consider consulting with appropriate persons within the firm or the organization that employs the member.

If a member decides not to consult with appropriate persons within the firm or the organization that employs the member and the conflict remains unresolved after pursuing the selected course of action, the member should consider either consulting with other individuals for help in reaching a resolution or obtaining advice from an appropriate professional body or legal counsel. The member also should consider documenting the substance of the issue, the parties with whom the issue was discussed, details of any discussions held and any decisions made concerning the issue.

If the ethical conflict remains unresolved, the member will in all likelihood be in violation of one or more rules if he or she remains associated with the matter creating the

conflict. Accordingly, the member should consider his or her continuing relationship with the engagement team, specific assignment, client, firm, or employer. [No prior reference: new content.]

2. What relevant facts and circumstances in this case should influence your ethical decision making process?

The relevant facts and circumstances of the case include:

1. You serve as the auditor for AMG.
2. It appears that fraud is taking place at AMG. AMG has not provided you with supporting documentation for the suspicious quarter end sales or their subsequent reversals. This is information that you need to complete audit work and issue an audit opinion in accordance with audit standards issued by the PCAOB.
3. The PCAOB audit standards must be followed.
4. The PCAOB standards on ethics and independence must be followed.
5. Since you are a member of the AICPA, the AICPA Code of Professional Conduct applies to you.
6. The Confidential Client Information Rule (1.700.001) of the AICPA Code of Professional Conduct prohibits you from disclosing any confidential client information without the client's consent.
7. Other SEC rules and regulations may be applicable.

3. What is the ethical dilemma in this case?

The main ethical dilemma facing the auditor is that there is an ethical conflict between disclosing the AMG fraud and maintaining client confidentiality. Specifically, according to AICPA Code of Professional Conduct Rule 1.000.020.01b (2018, 29), an ethical conflict arises when a member encounters "*Conflicts in applying relevant professional standards or legal standards.*" Rule 1.000.020.01 further provides the following specific example: "*a member suspects a fraud may have occurred, but reporting the suspected fraud would violate the member's responsibility to maintain client confidentiality.*"

4. Does your audit firm appear to have any specific internal procedures in place to deal with ethical dilemmas? If not, what internal procedures should your firm have in place?

It does not appear that your firm has any specific internal procedures in place to deal with ethical dilemmas. At the very least, your audit firm should have the following internal procedures in place:

1. An audit partner not involved in the audit should identify the ethical dilemma and suggest alternative courses of action. Given that this firm only has one Partner, perhaps another staff member, or the manager can help here.
2. Contact the AICPA Professional Ethics Division for consultation. Specifically, e-mail ethics@aicpa.org or call the Ethics Hotline at 1-888-777-7077.
3. Contact your firm's legal counsel for advice.

5. What alternative courses of action are available to you? What would be the best course of action for you to take in these circumstances?

This question has been deliberately left open ended to permit students to think through the alternative courses of action and their possible (intended or unintended) consequences.

Hopefully, students can quickly rule out the “*do nothing*” option recognizing that picking that option is likely to result in the most harm to themselves, their audit firm, as well as AMG’s owners. The alternative courses of action include:

1. Do nothing (i.e., proceed with the audit as normal).
2. Consult the AICPA Code of Professional Conduct for guidance.
3. Talk to the audit Partner (in this case there is only one Partner in this small firm). Rule 1.000.020.04 of the AICPA Code of Professional Conduct (AICPA, 2018) specifically states that the “*appropriate persons within the firm*” should be consulted.
4. Wait for the accounting manager to provide you with the missing (in reality the non-existent) supporting documentation for the quarter end sales and subsequent reversals.
5. Contact the AICPA Professional Ethics Division for consultation. It would be best to document this consultation (Rule 1.000.020.05).
6. Contact your firm’s legal counsel for advice. This consultation with the attorneys should also be documented (Rule 1.000.020.05).
7. Advise the Partner to withdraw from this audit engagement.
8. Resign/withdraw from this audit engagement of AMG (Rule 1.000.020.05 and Rule 1.000.020.06) and, if possible, hire your own personal legal counsel.
9. Resign from the audit firm (Rule 1.000.020.04 and Rule 1.000.020.06) and hire your own personal legal counsel.

Rule 1.000.020.02 of the AICPA Code of Professional Conduct (AICPA, 2018) states that you should consider the relevant facts and circumstances (answer to question 2 above), the ethical issues involved (answer to question 3 above) and any established internal procedures (answer to question 4 above) before determining the best course of action. The best course of action depends upon what happens next. If no supporting documentation is forthcoming (or if fabricated documentation is provided to you by AMG), then it would be best to consult with both the Partner and the firm’s legal counsel. In addition, it might be best for your firm to withdraw from this audit engagement and inform AMG’s audit committee of your suspicions. If this is not possible, it is likely the best course of action for you is to resign from AMG’s audit and/or to resign from the firm and also inform AMG’s audit committee of your suspicions. In either case, it would probably be to your benefit to hire your own, personal legal counsel.

Question Number	Inadequate 0-4	Adequate 5-8	Superior 9-10
What general guidance does the AICPA Code of Professional Conduct provide to auditors faced with an ethical dilemma? Provide specific citations in your answer.	Framework for making ethical decisions not cited.	Framework for making ethical decisions cited but incomplete.	Framework for making ethical decisions properly cited.
What relevant facts and circumstances in this case should influence your ethical decision making process?	Few relevant facts that influence the auditor’s ethical decision making process are included.	Some relevant facts that influence the auditor’s ethical decision making process are included.	Most relevant facts that influence the auditor’s ethical decision making process are included.
What is the ethical dilemma in this case?	The ethical dilemma is not identified.	The ethical dilemma is incorrectly identified.	The ethical dilemma is correctly identified.

Does your audit firm appear to have any specific internal procedures in place to deal with ethical dilemmas? If not, what internal procedures should your firm have in place?	Few internal procedures which should be in place are properly documented.	Some internal procedures which should be in place are properly documented.	Most internal procedures which should be in place are properly documented.
What alternative courses of action are available to you? What would be the best course of action for you to take in these circumstances?	Courses of action were not thoroughly documented. No best course of action was specified.	Some courses of action were well documented. The best course of action is partially specified, or vaguely specified.	Most courses of action were well documented. The best course of action is clearly specified and explained.

Learning Objectives	Inadequate 0-4	Adequate 5-8	Superior 9-10
Understanding the ethical conflict resolution framework identified in the AICPA Code of Professional Conduct.	Incomplete understanding of the ethical conflict resolution framework identified in the AICPA Code of Professional Conduct.	Some understanding of the ethical conflict resolution framework identified in the AICPA Code of Professional Conduct.	Thorough understanding of the ethical conflict resolution framework identified in the AICPA Code of Professional Conduct.
Applying this ethical decision making framework to questions that arise from a specific set of circumstances that occurred in a real audit situation.	Incomplete analysis of the AICPA guidance applied to resolution of ethical dilemmas.	Effective analysis of the AICPA guidance applied to resolution of ethical dilemmas.	Thorough analysis of the AICPA guidance applied to resolution of ethical dilemmas.

Discussion Question	Inadequate 0-4	Adequate 5-8	Superior 9-10
Writing	Writing includes several errors in spelling and grammar, punctuation and sentence structure. Lacks clarity; not organized.	Writing includes few errors in spelling and grammar, punctuation and sentence structure. Some clarity; somewhat organized.	Writing does not reflect errors in spelling and grammar, punctuation and sentence structure. Clear and concise; well-organized.
Comprehension	Does not demonstrate an understanding of the concepts.	Demonstrates some understanding of the concepts.	Demonstrates a proficient understanding of concepts.
Analysis	Analysis of questions is not complete.	Some analysis of questions is evident.	The analysis of questions is thorough.

CONCLUSION

There is a shortage of cases that can be used in an auditing course to help students understand and use the ethical decision making framework that is incorporated into the AICPA Code of Professional Conduct. Loosely based upon an actual enforcement action brought by the SEC against a practicing auditor, this case helps alleviate this shortage and enables students to identify and then apply the ethical conflict resolution framework described in the AICPA Code of Professional Conduct. Students are asked to put themselves in the shoes of the auditor conducting the annual audit of AMG Incorporated's financial statements. Students then have to use the guidance provided in the AICPA Code of Professional Conduct to help resolve the ethical conflict between their suspicions that accounting fraud might be taking place at their client with the "confidentiality rule" which implies that reporting their suspicions would violate their obligation to maintain the confidentiality of their client. In addition to filling the void from the lack of cases that require use of the ethical decision making framework, this case provides an engaging learning tool that facilitates discussion and a more active learning environment. Further, by putting themselves in the shoes of the auditor, students have an opportunity to role play and therefore help develop their problem solving and communication skills.

DISCLAIMER

This case is written using publicly available information to provide a setting for student learning. It is not intended to provide commentary on or evaluation of the effectiveness or appropriateness of any party's handling of the situation described. Certain names and other information have been changed in order to highlight certain issues and in order to maintain confidentiality and privacy.

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